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# The Applicability of Deepening Insolvency as a Claim Against the Management of Nonprofit Corporations

Benjamin Gerber\*

Even when a corporation is insolvent, its corporate property may have value. The fraudulent and concealed incurrence of debt can damage that value . . . . The very threat of bankruptcy, brought about through fraudulent debt, can shake the confidence of parties dealing with the corporation, calling into question its ability to perform, thereby damaging [corporate] assets, the value of which often depends on the performance of other parties. . . . [P]rolonging an insolvent corporation's life through bad debt may simply cause the dissipation of corporate assets.

These harms can be averted, and the value within an insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt.<sup>1</sup>

## I. INTRODUCTION

As courts have expanded the boundaries of corporate manager liability, deepening insolvency as a claim for relief has gained recognition. Since its inception, detractors of deepening insolvency have believed that a distressed corporation's acquisition of additional debt causes negligible harm to its operation and beneficiaries. It is this Note's goal to demonstrate that this belief is wrong as applied to a nonprofit corporation. Through the discussion of the Third Circuit's decision in *In re Lemington Home for the Aged*, precedent, existing claims, and policy, this Note will show that a viable deepening insolvency claim is necessary to remedy the harms created by the wrongful prolongation of a distressed nonprofit corporation.

A well-run assisted living center is a busy place: employees lead residents in exercise programs, organize social activities, serve meals, spend time with residents, and provide security. Residents and their families entrust employees of these facilities to care for individuals that desire, or require, other people to supervise and manage their lives each day. When managers of such facilities execute their fiscal

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1. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349–50 (3d Cir. 2001) (citations omitted).

responsibilities in a negligent or fraudulent manner, their corporate actions jeopardize the facility and its residents' lives. The Lemington Home for the Aged (the Home) experienced this precise situation; however, a deepening insolvency claim prevented its directors and officers from immunity.

Part II of this Note discusses prior interpretations of deepening insolvency. Part III explores the *In re Lemington Home for the Aged* decision in which the Third Circuit implicitly ruled that nonprofit directors should be subject to deepening insolvency as a theory of liability. Part IV argues that the existing differences between for-profit and nonprofit corporations require that a claim of deepening insolvency fill the gap that has allowed nonprofit directors and officers to abuse their fiduciary duties without retribution. Part V expands on deepening insolvency's impact on the beneficiaries of nonprofit corporations. Finally, in Part VI, this Note concludes that the Third Circuit's holding should place nonprofit directors in a more vulnerable position because current liability claims cannot rectify the consequences of a director-prolonged nonprofit corporation.

## II. BACKGROUND

Claims of deepening insolvency have had a presence in corporate litigation for over thirty years.<sup>2</sup> Although the claim is a question of state law,<sup>3</sup> it often arises in bankruptcy proceedings.<sup>4</sup> Part II(A) traces the development of deepening insolvency. Part II(B) will show that the courts have many interpretations of the claim. Lastly, Part II(C) will review the elements necessary to bring a valid claim of deepening insolvency.

Before tracing the development of deepening insolvency, it is important to understand the basic definitions of insolvency, a corporation's path to insolvency, and the defenses afforded to corporate management if insolvency leads to litigation. Two commonly accepted tests of insolvency are the balance sheet test and the equity test.<sup>5</sup>

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2. See, e.g., *Bloor v. Dansker (In re Investors Funding Corp. of N.Y. Sec. Litig.)*, 523 F. Supp. 533 (S.D.N.Y. 1980).

3. Elizabeth V. Tanis & Jennifer D. Fease, *Emerging Issues in Deepening Insolvency Claims*, 42 REV. SEC. & COMMODITIES REG. 239, 240 (2009).

4. See generally Sara E. Apel, Comment, *In Too Deep: Why the Federal Courts Should Not Recognize Deepening Insolvency as a Cause of Action*, 24 EMORY BANKR. DEV. J. 85 (2008) (noting that trustees and creditor committees assert claims of deepening insolvency when they believe boards of directors have fraudulently prolonged an already insolvent corporation's life, forcing it to file bankruptcy).

5. 15A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 7360 (perm. ed., rev. vol. 2012).

Under the balance sheet test, a corporation is insolvent if its debts are greater than its assets at fair market value.<sup>6</sup> The Bankruptcy Act of 1898 adopted this approach.<sup>7</sup> The equity test refers to insolvency as the inability of a corporation to pay its debts as they become due in the usual course of business.<sup>8</sup> Some commentators consider the equity test so expansive that insolvency may refer to a debtor's general inability to meet fiscal obligations as they mature.<sup>9</sup> It does not matter that a corporation's assets exceed its liabilities; a corporation becomes insolvent when its assets cannot satisfy its debt obligations.<sup>10</sup> In the absence of an accepted standard within a particular jurisdiction, courts may apply either test to determine when a corporation has entered the zone of insolvency.<sup>11</sup>

### A. *Business Tort Claims and Insolvency*

Many scenarios may cause a corporation to become insolvent. A corporation may become insolvent because of a decrease in revenue, an increase in expenses through negligent or fraudulent management, or poor industry conditions.<sup>12</sup> In general, a board of directors owes a duty of care, good faith, and loyalty,<sup>13</sup> but when a corporation be-

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6. 11 U.S.C.A. § 101(32)(A) (West 2006). For example, a coffee shop is insolvent when the money owed to its coffee bean suppliers is greater than its expected income from selling all of its coffee at a competitive price.

7. John C. McCoid II, *The Occasion for Involuntary Bankruptcy*, 61 AM. BANKR. L.J. 195, 196 (1987) (citing 11 U.S.C.A. § 101(31)).

8. FLETCHER ET AL., *supra* note 5, § 7360.

9. *Id.*

10. *Id.*

11. See Nancy A. Peterman & Sherri Morissette, *Directors' Duties in the Zone of Insolvency: The Quandary of the Nonprofit Corp.*, 23 AM. BANKR. INST. J., Mar. 2004, at 12.

12. John T. Goodwin, *The Doctrine of Deepening Insolvency in Bankruptcy* 4 (Dec. 2, 2008) (unpublished comment), available at <http://lawlib.wlu.edu/lexopus/works/332-1.pdf>; see also MODEL BUS. CORP. ACT § 8.30 (2007) (noting that a corporate director must discharge its duties in good faith and in a manner the director reasonably believes to be in the best interests of the corporation whether or not the director has the required knowledge). Compare Ramesh K.S. Rao et al., *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. CORP. L. 53 (1996) (explaining that corporations that have directors who follow such standards can still become insolvent from operational inefficiencies and consumer preference), with Leonard I. Rotman, *Fiduciary Law's "Holy Grail": Reconciling Theory and Practice in Fiduciary Jurisprudence*, 91 B.U. L. REV. 921 (2011) (noting that directors that fail to act in the best interests of the corporation have been found liable for failing to perform their corporate duties).

13. 15 PA. CONS. STAT. ANN. § 5712 (West 2011). "A director . . . shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in *good faith*, in a manner he reasonably believes to be in the *best interests of the corporation* and with such *care*, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances." *Id.* (emphasis added).

comes insolvent, the directors' fiduciary duties shift from its stockholders and other equity owners to its creditors.<sup>14</sup>

If a corporation's capital contributors wish to sue its directors for a breach of fiduciary duty, they must overcome the business judgment rule and must have not been part of the directors' fraud or wrongdoing (also known as the directors' *in pari delicto* defense). Under the business judgment rule, courts will not question a business decision absent evidence of abuse of discretion.<sup>15</sup> Courts operate under the presumption that directors will act on an informed basis, in good faith, and in the honest belief that their decisions are for the good of the corporation.<sup>16</sup> Nonetheless, a plaintiff has the burden to rebut this presumption by proving that the directors (1) failed to take action, (2) made an uninformed decision, (3) made a decision that was not in good faith, or (4) had a financial interest in the outcome of the decision.<sup>17</sup>

Even if a plaintiff successfully rebuts the presumption offered by the business judgment rule, the doctrine of *in pari delicto* may still protect the defendant. *In pari delicto* is a significant barrier to successfully alleging tortious conduct against corporate management.<sup>18</sup> Unlike the business judgment rule, a corporate defendant must affirmatively assert *in pari delicto* to prevent the plaintiff from recovering damages.<sup>19</sup> It also precludes plaintiff trustees and creditor committees from filing suit if they have benefited from director mal-

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14. Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COM. L.J. 295, 300 (2004) (noting that creditors have a great interest in the value of a corporation's assets because it is from these assets that they will be paid).

15. See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 266–67 (Del. 2000) (noting that shareholders' mere disagreement cannot serve as grounds for imposing liability).

16. *Id.* at 251.

17. See generally *id.* (explaining that the plaintiff did not rebut the presumption).

18. See Amelia Toy Rudolph et al., *Invoking in Pari Delicto to Bar Accountant Liability Actions Brought by Trustees and Receivers*, WL ST004 ALI-ABA 75, 77 (ALI-ABA Course of Study, Sept. 15–16, 2011) (stating that the defense is a “complete bar to an action asserted by a plaintiff who is equally at fault for the wrongdoing giving rise to the plaintiff's claim”).

19. See, e.g., *Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PricewaterhouseCoopers, LLP*, 989 A.2d 313, 329 (Pa. 2010) (“[T]he plaintiff [must] be an active, voluntary participant in the wrongful conduct or transaction(s) for which it seeks redress, and bear substantially equal [or greater] responsibility for the underlying illegality as compared to the defendant.” (internal quotation marks omitted)), *vacated on remand*, 607 F.3d 346 (3d Cir. 2010) (explaining that the Third Circuit vacated the initial judgment in favor of the third-party auditor because the Supreme Court of Pennsylvania had recently clarified the test of imputation and the district court did not consider whether the auditor dealt with the foundation in good faith).

feasance.<sup>20</sup> However, the adverse interest exception<sup>21</sup> refutes the *in pari delicto* defense if the alleged wrongdoing did not benefit the plaintiff.<sup>22</sup>

### B. *The Precedent of Deepening Insolvency*

Deepening insolvency claims are relatively new compared to claims for breach of fiduciary duty and other traditional business torts. The court in *In re Investors Funding Corporation of New York Securities Litigation* inadvertently laid the groundwork for a deepening insolvency claim.<sup>23</sup> In the case, plaintiff trustees sued a corporation's auditor for creating a false image of financial health through a series of sham transactions designed to show artificial profits and conceal losses.<sup>24</sup> The auditor, in its defense, argued that any fraud perpetrated actually benefited the trustees by allowing the corporation to continue operations past the point of insolvency.<sup>25</sup> The court rejected the auditor's argument and reasoned that "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."<sup>26</sup> Thus, it held that the prolonged solvency of the debtor solely benefited the auditor.<sup>27</sup> By recognizing the dynamic relationship between a corporation and its financial contributors, the court created the foundation for deepening insolvency.<sup>28</sup>

Soon after the Southern District of New York established deepening insolvency's base, the Seventh Circuit allowed a deepening insolvency claim against directors and officers that had prolonged the life of an insolvent corporation, thereby deepening its debt.<sup>29</sup> The Director of the Illinois Department of Insurance sued the directors of an insurance corporation because the corporate directors allowed the in-

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20. See, e.g., *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 356 (3d Cir. 2001) (noting that the trustee can only assert actions available by the debtor or creditor, and it is subject to the same defenses as could have been asserted by the corporation).

21. "[C]ourts impute the fraud of an officer to a corporation when the officer commits the fraud (1) in the course of his employment, and (2) to the benefit of the corporation." *Id.* at 358 (setting a test to determine whether adverse interest is present).

22. *Allegheny*, 989 A.2d at 333 ("[W]here an agent acts in his own interest, and to the corporation's detriment, imputation generally will not apply.").

23. See *Bloor v. Dansker (In re Investors Funding Corp. of N.Y. Sec. Litig.)*, 523 F. Supp. 533, 541 (S.D.N.Y. 1980) (noting that a false financial picture enabled the corporation's management "to raise capital for [its] further plundering").

24. *Id.*

25. See *id.*

26. *Id.*

27. *Id.*

28. *In re Investors Funding Corp. of N.Y. Sec. Litig.*, 523 F. Supp. at 541 (citing the claim as a justification for recognizing an "adverse interest" exception).

29. See *Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir. 1983).

solvent insurance corporation to take on an additional liability that consequently damaged the corporation, its policyholders, and creditors.<sup>30</sup> In denying the directors' motion to dismiss, the court stated that the prolongation of corporate life is not a benefit to corporate shareholders because they are last in line for recovery in bankruptcy liquidation.<sup>31</sup>

Although deepening insolvency has a history rich in finding director liability, the courts have inconsistently applied this tort. Courts have treated deepening insolvency inconsistently because of the difficulty harmonizing the varying judicial decisions with the Bankruptcy Code and other law.<sup>32</sup> Court determinations on deepening insolvency differ: some find it a valid independent claim for relief, some find it valid only for measuring damages, and still others refuse to recognize it.

For example, the Western District of Pennsylvania has held deepening insolvency a valid independent claim where a third-party accounting firm knowingly aided corporate directors in misstating a Pennsylvania nonprofit's financial condition.<sup>33</sup> In another instance, the Southern District of New York found deepening insolvency to be a valid measure of damages where plaintiff nonprofit corporation relied on financial misstatements that prevented it from filing for bankruptcy earlier.<sup>34</sup> In addition, the Bankruptcy Court for the District of Delaware has held deepening insolvency to be a valid claim where a syndicate of lenders extended a business an additional two years under the fraudulent guise of renegotiating financial covenants.<sup>35</sup>

However, another court has held that deepening insolvency was not a valid theory of damages for corporate malpractice.<sup>36</sup> The Delaware

30. *Id.* at 1345.

31. *Id.* at 1348.

32. See Tanis & Fease, *supra* note 3, at 240; see also TaeRa K. Franklin, *Deepening Insolvency: What It Is and Why It Should Prevail*, 2 N.Y.U. J.L. & Bus. 435, 443 (2006) (noting that federal courts are left to determine and infer how the relevant state courts would rule).

33. See Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PricewaterhouseCoopers, LLP, No. 2:00cv684, 2007 WL 141059, at \*12, \*15 (W.D. Pa. Jan. 17, 2007), certifying question to No. 07-1397, 2008 WL 3895559 (3d Cir. July 1, 2008), answering certified question 989 A.2d 313 (Pa. 2010).

34. *In re Parmalat Sec. Litig.*, 501 F. Supp. 2d 560, 578 (S.D.N.Y. 2007) ("[W]hile the inurrence of debt by itself cannot deepen a company's insolvency, the [c]ourt is not prepared to conclude that it never can cause injury to an insolvent company."), *affg sub nom.* Pappas v. Bank of Am. Corp., 309 F. App'x 536 (2d Cir. 2009). However, the court found that the plaintiffs did not adequately allege the required fraud. *Id.* at 581-87.

35. See Official Comm. of Unsecured Creditors v. Credit Suisse First Bos. (*In re Exide Techs., Inc.*), 299 B.R. 732, 750-52 (Bankr. D. Del. 2003).

36. See Seitz v. Detweiler, Hershey & Assocs., P.C. (*In re CitX Corp.*), 448 F.3d 672 (3d Cir. 2006) (concluding that proof of negligence was not sufficient to bring a claim for deepening insolvency).

Court of Chancery has stated that it does not recognize deepening insolvency as an independent claim because suits that allege fraud and a breach of fiduciary duty already protect investors and provide insulation to directors in the zone of insolvency.<sup>37</sup> A Texas bankruptcy court has followed Delaware's belief that deepening insolvency is duplicative and collapses other established business torts.<sup>38</sup>

Although deepening insolvency's precedent differs in application, most scholars agree that the most notable opinion on deepening insolvency is the decision from *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*<sup>39</sup>

In *Lafferty*, the Third Circuit held that the Pennsylvania Supreme Court could recognize the tort of deepening insolvency as an independent claim.<sup>40</sup> The issue involved claims that a third party fraudulently induced two lease financing corporations to issue fraudulent debt certificates that resulted in deepening the corporations' insolvency and forcing them into bankruptcy.<sup>41</sup> The plaintiff committee of creditors brought claims against the defendant directors and asserted that they had mismanaged the corporation and breached their fiduciary duties to its debtors by failing to supervise and oversee the corporations' affairs.<sup>42</sup>

At the time of this case, Pennsylvania had not yet addressed deepening insolvency.<sup>43</sup> The court stated that Pennsylvania's highest court

37. See *Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168, 205 (Del. Ch. 2006).

38. See, e.g., *Official Comm. of Unsecured Creditors of VarTec Telecom, Inc. v. Rural Tel. Fin. Coop. (In re VarTec Telecom Inc.)*, 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005) ("Put more bluntly, if you honestly treat deepening insolvency as a tort, it collapses into already existing torts, be it a breach of fiduciary duty . . . accounting malpractice . . . or some other cause of action." (internal quotation marks omitted)).

39. See, e.g., Sabin Willett, *The Shallows of Deepening Insolvency*, 60 BUS. LAW. 549, 564 (2005) (recognizing that *Lafferty* is perhaps the leading decision on deepening insolvency today); Lauren Colasacco, Note, *Where Were the Accountants? Deepening Insolvency as a Means of Ensuring Accountants' Presence when Corporate Turmoil Materializes*, 78 FORDHAM L. REV. 793, 827 (2009) (noting that *Lafferty* is the pivotal case that defined deepening insolvency as an independent tort); Goodwin, *supra* note 12, at 21 ("[T]he *Lafferty* decision has been one of the most influential deepening insolvency cases, and has frequently been cited as allowing deepening insolvency theory both as a cause of action, and as a theory of harm."); Edward E. Neiger, *Third Circuit Limits Scope of Liability for "Deepening Insolvency"*, BANKR. BULL., Aug. 2006, at 4, available at [http://www.weil.com/wgm/cwgmhomep.nsf/Files/BBAug06/\\$file/BBAug06.pdf](http://www.weil.com/wgm/cwgmhomep.nsf/Files/BBAug06/$file/BBAug06.pdf) ("Most complaints asserting a claim of deepening insolvency cite *Lafferty* either as binding or persuasive precedent.").

40. *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 347 (3d Cir. 2001) (noting that deepening insolvency is "an injury to the Debtors' corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life").

41. The lease financing corporations were incidentally involved in a Ponzi scheme as well. *Id.* at 344-45.

42. *Id.* at 346.

43. *Id.* at 349.



could accept that “deepening insolvency may give rise to a cognizable injury”<sup>44</sup> because of its sound theory,<sup>45</sup> its growing acceptance among other courts,<sup>46</sup> and because its “remedial theme” paralleled the principles of the state’s jurisprudence.<sup>47</sup> Although the court never articulated the elements or legal standards for the claim,<sup>48</sup> *Lafferty* is the modern standard for deepening insolvency.

### C. Requirements to Bring a Successful Claim of Deepening Insolvency

Jurisdictions that recognize deepening insolvency as a valid claim define it as “an injury to [a debtor’s] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.”<sup>49</sup> A claim of deepening insolvency requires “(1) fraud, (2) which cause[d] the expansion of corporate debt, and (3) which prolong[ed] the life of [a] corporation.”<sup>50</sup> The Third Circuit further expanded on the requirement to bring a claim for deepening insolvency in a decision in which it determined that the plaintiff must establish that the alleged tortious party caused the deepening of insolvency<sup>51</sup> through

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44. *Id.* (internal quotation marks omitted).

45. See *Lafferty*, 267 F.3d at 349–50 (noting that a corporation’s property still has value even during insolvency). The fraudulent concealment of debt can force the corporation into bankruptcy, which creates operational limitations that hurt a corporation’s ability to run its business. *Id.* It can undermine corporate relationships of customers and investors, thus leading to the dissipation of its assets. *Id.*

46. See *id.* at 350–51.

47. *Id.* at 352. One of the most venerable principles of Pennsylvania common law is that the law provides a remedy whenever there is injury, and when directors cause damage to corporate property, the court should recognize a cause of action for such an injury. See *Lafferty*, 267 F.3d at 351 (citing *Schweitzer v. Consol. Rail Corp.*, 758 F.2d 936, 942 (3d Cir. 1985)) (noting that an identifiable and compensable injury is essential to the existence of tort liability). In *Lafferty*, the defendant directors challenged this rationale based on the notion that the committee had no standing to assert claims on behalf of the creditors. *Id.* Although the court dismissed this assertion because the committee brought its claim on behalf of the debtors, critics have dismissed this defense, and some courts currently allow bankruptcy trustees to bring corporate malfeasance claims on behalf of creditors. See Cieri & Riela, *supra* note 14, at 303–06.

48. See *Lafferty*, 267 F.3d at 360 (affirming the district court’s motion to dismiss and finding that the *in pari delicto* defense barred the committee from recovering for the directors’ fraudulent conduct).

49. *Id.* at 347.

50. Official Comm. of Unsecured Creditors v. Foss (*In re Felt Mfg. Co.*), 371 B.R. 589, 621 (Bankr. D.N.H. 2007) (citing *Lafferty*, 267 F.3d at 344).

51. *Seitz v. Detweiler, Hershey & Assocs., P.C. (In re CitX Corp.)*, 448 F.3d 672, 678 (3d Cir. 2006) (noting that whatever harm occurred to the plaintiff was a result of the damage caused by the defendant).

fraudulent conduct.<sup>52</sup> The Supreme Court of Pennsylvania has provided a general rule of fraud:

[F]raud consists in anything calculated to deceive, whether by single act or combination, or by suppression of truth, or a suggestion of what is false, whether it be by direct falsehood or by innuendo, by speech or silence, word of mouth, or look or gesture. It is any artifice by which a person is deceived to his disadvantage.<sup>53</sup>

Furthermore, a court must determine the causation requirement of deepening insolvency on a case-by-case basis.<sup>54</sup> Traditionally, tort claims require both proximate cause and foreseeability.<sup>55</sup> The plaintiff must introduce evidence that allows for the court to reasonably conclude that the defendant's conduct was more likely than not the cause of the harm.<sup>56</sup> Proximate cause requires proof of exceptional or obvious circumstances involving fraud or similar misconduct because the success or failure of a corporation depends on multiple factors, some of which are outside of the control of directors and officers.<sup>57</sup>

The third requirement—establishing that the expansion of debt prolonged the life of the corporation—is both the foundation of deepening insolvency and its most contested element because of its clash with the business judgment rule. Deepening insolvency relies on the assumption that the prolongation of a corporation's life is a legally cognizable harm;<sup>58</sup> however, this assumption conflicts with the business judgment rule's assumption that directors should not liquidate a corporation at the first sign of insolvency.<sup>59</sup> The elements needed to establish a claim of deepening insolvency are still in development. Although the Southern District of New York outlined a potentially compatible hurdle for deepening insolvency by surveying the actual use of the assets obtained during insolvency,<sup>60</sup> common law will dic-

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52. *Id.* at 681. The court in *In re CitX Corp.* noted *Lafferty's* definition of “the injury as a fraudulent expansion of corporate debt.” *Id.* (quoting *Lafferty*, 267 F.3d at 349) (internal quotation marks omitted).

53. *In re Reichert's Estate*, 51 A.2d 615, 617 (Pa. 1947) (quoting *Wiley v. Wirbelauer*, 116 N.J. Eq. 391, 396 (N.J. Ch. 1934)) (internal quotation marks omitted).

54. See Colasacco, *supra* note 39, at 858.

55. See Douglas R. Richmond et al., *Lawyer Liability and the Vortex of Deepening Insolvency*, 51 ST. LOUIS U. L.J. 127, 158–59 (2006); see also RESTATEMENT (THIRD) OF TORTS §§ 1, 29, 33 (2010). Because deepening insolvency has yet to be established as a cause of action, the courts have not set out all of the elements required for causation. This Note acknowledges this open field and indicates some general requirements of causation articulated by other scholars.

56. Richmond, *supra* note 55, at 157.

57. *Id.* at 158.

58. See Apel, *supra* note 4, at 107.

59. See *id.*

60. See *In re Parmalat Sec. Litig.*, 501 F. Supp. 2d 560, 576, 580 (S.D.N.Y. 2007) (looking to the third-party defendant's work for the corporation to determine if it was reasonably foreseeable that defendant knew of looting of corporate assets), *affg sub nom.* *Pappas v. Bank of Am.*

tate its interpretation until the Supreme Court or Congress establishes its requirements.

### III. SUBJECT OPINION: *IN RE LEMINGTON HOME FOR THE AGED*

In the *In re Lemington Home for the Aged* decision, the Third Circuit determined that the Committee of Creditors (the Committee) should not be foreclosed from bringing a deepening insolvency claim against a nonprofit board of directors and officers.<sup>61</sup> Further judicial support of this decision would likely amend the expected duties of nonprofit directors and extend the breadth of deepening insolvency as an independent claim. Part III(A) discusses the facts of *In re Lemington Home for the Aged*. Part III(B) reviews the proceedings of the dispute. Part III(C) considers the rationale and explanation for the court's holding by looking at a breach of fiduciary duty and its defenses in conjunction with a deepening insolvency claim.

#### A. *Facts of In re Lemington Home for the Aged*

The Home<sup>62</sup> was an elderly care facility located in Pittsburgh, Pennsylvania.<sup>63</sup> In the early 1980s, the Home merged with its parent company, Lemington Elder Care Services (Elder Care), under a single board of directors.<sup>64</sup> Shortly after joining Elder Care, the directors began aggressive marketing strategies to produce an even revenue mix of Medicare, Medicaid, and private pay to fund the Home; however, the campaign was not successful, and the Home slipped into significant financial trouble.<sup>65</sup> Although private foundations tried to keep it afloat, the Home filed for Chapter 11 bankruptcy on April 13, 2005,<sup>66</sup> and the Committee sued the Home's management claiming that it breached its fiduciary duty and deepened the Home's insolvency, causing irreparable harm.<sup>67</sup>

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Corp., 309 F. App'x 536 (2d Cir. 2009); see also Tanis & Fease, *supra* note 3, at 247–48. The Note will address this approach in Part IV.

61. See Official Comm. of Unsecured Creditors v. Baldwin (*In re Lemington Home for the Aged*), 659 F.3d 282, 295 (3d Cir. 2011) (finding a genuine issue of material fact as to whether the defendants fraudulently contributed to deepening the insolvency of the Home).

62. The Third Circuit's opinion often refers to the Home as the "Lemington Center." *Id.* at 285.

63. *Id.*

64. *Id.*

65. In its first year, the Home lost \$429,000. *Id.* The Home's total liabilities exceeded its total assets by \$1,941,959 and \$1,675,397 in 2002 and 2003, respectively. *In re Lemington Home for the Aged*, 659 F.3d at 286.

66. *Id.* at 288.

67. *Id.* at 285.

During its time under Elder Care, the Home failed to meet a number of regulations that made it impossible for the Home to generate the income necessary to operate. For example, on June 9, 2005, a bankruptcy court directed the defendants to obtain a viability study on its current financial condition.<sup>68</sup> The auditor, PrimusCare, concluded that the Home could not operate in its current condition even though it operated in an area with a high population of senior citizens, had support from the local government and community, and could obtain a significant amount of funding by collecting approximately \$500,000 in its unpaid Medicare reimbursements.<sup>69</sup> Between affiliating with Elder Care and filing for bankruptcy, the Home operated without a treasurer.<sup>70</sup> The Home also employed a part-time administrator, which violated the Pennsylvania law that required it to employ someone full-time.<sup>71</sup>

Furthermore, the Home's officers failed to maintain financial records and take minutes at executive meetings.<sup>72</sup> Defendant James Shealey became the Home's chief financial officer in December 2002.<sup>73</sup> An investigation by the Committee revealed that while Shealey was CFO a general ledger and accounting system had not been maintained "for some time," accounting record problems had existed since November 2003, and no Medicare billings had been submitted since August 2004.<sup>74</sup> The investigation concluded that Shealey's actions resulted in a failure to submit over \$450,000 of payables during one year.<sup>75</sup> Although the directors were aware as early as December 2004 that Shealey was not maintaining financial records, the board continued to rely on his advice.<sup>76</sup> In addition, the directors did not disclose their decision to stop admitting new patients and close

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68. *Id.* at 288.

69. *Id.* at 288–89.

70. *In re Lemington Home for the Aged*, 659 F.3d at 286 ("From November 2003 to January 2005, the Board position of Treasurer was vacant.").

71. Defendant Melody L. Causey was the Home's administrator from September 1997 to March 2005. *Id.* at 286–87. In April or May of 2004, Causey's physicians placed her on a part-time work status that required her to be absent from the home for six to eight weeks at a time. *Id.* at 286. The directors did not hire a replacement or substitute until March 2005 even though the State of Pennsylvania required the Home to employ a full-time administrator. *Id.* at 287.

72. *Id.* at 287 (stating that the administrator admitted that minutes were never kept during executive meetings at which compensation was discussed and that the only evidence of decisions were handwritten notes).

73. *In re Lemington Home for the Aged*, 659 F.3d at 286.

74. *Id.* at 288 (internal quotation marks omitted).

75. *Id.* at 291.

76. *Id.* at 287.

the Home.<sup>77</sup> Moreover, “[t]hese troubling circumstances were further exacerbated by alleged efforts to transfer the Home’s principal charitable asset to an affiliated entity that had the same board of directors.”<sup>78</sup>

### B. *Procedural History*

On April 13, 2005, the Home filed a voluntary Chapter 11 bankruptcy petition, and two weeks later, the bankruptcy court appointed the Committee.<sup>79</sup> After no entity expressed interest in funding or acquiring the Home, the Bankruptcy Court for the Western District of Pennsylvania approved closure of the Home and the transfer of its residents to other facilities.<sup>80</sup> The Committee<sup>81</sup> and a third party revealed financial and operational problems from an investigation into the board’s actions.<sup>82</sup> On November 27, 2005, the Committee filed suit against the directors and officers.<sup>83</sup> Subsequently, the Committee amended its complaint and asserted causes of action for breach of the defendants’ fiduciary duty of care and deepening insolvency.<sup>84</sup>

The Committee alleged that the directors, by failing to supervise the officers who were grossly negligent with the Home’s financial information and proximately caused the unnecessary bankruptcy filing,<sup>85</sup>

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77. *Id.* (noting that at a January 6, 2005 meeting the board voted to close the Home and agreed to stop admitting new patients to the home effective immediately).

78. Joao F. Magalhaes & Adam D. Wolper, *The Sword and the Shield: More on the Old Tale of Deepening Insolvency and in Pari Delicto Doctrine*, AM. BANKR. INST. J., Dec. 2011/Jan. 2012, at \*74–75; see *In re Lemington Home for the Aged*, 659 F.3d at 287–88 (“Handwritten notes from a Board meeting held on March 15, 2005 indicate discussion of plans to transfer the Home’s principal charitable asset, the Lemington Home Fund, held by the Pittsburgh Foundation, to Lemington Elder Care, an affiliated entity. The members of the Home’s Board were also directors of Lemington Elder Care. . . . On March 24, 2005, a document called the Lemington Elder Care Transition Action Plan was created, which, among other things, provided for the Lemington Elder Services restructuring process, to [c]lose Lemington Nursing Home and Assisted Living Facilities, [o]btain funding to assist with the transition and restructuring of Lemington Elder Care, [e]nlist all possible selling options of the Lemington Nursing Home and Assisted Living Facility, [c]onduct Bankruptcy Filing of Lemington Nursing Home & Assisted Living Entities, and [r]estructure Lemington Elder Care to include Community Services.” (citation omitted) (internal quotation marks omitted)).

79. *In re Lemington Home for the Aged*, 659 F.3d at 287–88 (noting that the directors considered filing for bankruptcy or restructuring the Home, but decided to close the home instead).

80. *Id.* at 289.

81. The Lemington creditors investigated the Home’s financial situation in May 2005. *Id.* at 288.

82. The bankruptcy court hired PrimusCare to obtain a viability study of the Home in June 2005. See *id.*

83. *Id.*

84. *In re Lemington Home for the Aged*, 659 F.3d at 289.

85. See *id.* at 291.

breached their duty of care.<sup>86</sup> The Committee also claimed that the directors breached their duty of care when they stopped admitting new patients because, according to another third-party report, the Home could have continued operations in the current market.<sup>87</sup> Lastly, the Committee claimed that the defendants' fraudulent actions and omissions resulted in the deepening insolvency of the Home.<sup>88</sup>

Nonetheless, the district court granted the defendants' joint motion for summary judgment.<sup>89</sup> The district court reasoned that the Committee's claim did not have enough facts to rebut the presumption of the business judgment rule.<sup>90</sup> In addition, the court concluded that there was not enough evidence to prove that the officers acted with reckless disregard or gross negligence in discharging their duties,<sup>91</sup> and it found no genuine dispute of material fact regarding the fraud claims required for deepening insolvency.<sup>92</sup> The district court stated that a reasonable trier of fact would be able to find that the defendants' actions<sup>93</sup> amounted only to negligence.<sup>94</sup>

### C. *The Third Circuit's Opinion in In re Lemington Home for the Aged*

On appeal by the Committee, the Third Circuit vacated the district court's grant of summary judgment and remanded the issues for further determination after concluding that genuine issues of material fact existed concerning the directors' self-dealing and fraud.<sup>95</sup>

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86. *See id.* at 288–89.

87. Official Comm. of Unsecured Creditors *ex rel.* Lemington Home for the Aged v. Baldwin, No. 10cv800, 2010 WL 4275252, at \*12 (W.D. Pa. Oct. 25, 2010), *vacated*, 659 F.3d 282 (3d Cir. 2011); *see also supra* note 68 and accompanying text (discussing the auditor's investigation).

88. *Baldwin*, 2010 WL 4275252, at \*12.

89. *Id.*; *see also In re Lemington Home for the Aged*, 659 F.3d at 289 (stating that the directors and officers filed a joint motion for summary judgment).

90. *Baldwin*, 2010 WL 4275252, at \*12.

91. *Id.*

92. *Id.*

93. *Id.* (alleging that the defendants stopped admitting patients to the Home causing it financial harm, paid attorney and accountant fees to shift resources to Elder Care, failed to collect over \$400,000 in Medicare reimbursements, misrepresented to the bankruptcy court that they were pursuing a purchaser for the Home when they were not, and concealed the misuse of the Home's funds by not maintaining accurate financial records).

94. *Id.*

95. Official Comm. of Unsecured Creditors v. Baldwin (*In re Lemington Home for the Aged*), 659 F.3d 282, 295 (3d Cir. 2011).

## 1. Genuine Issues of Fact Existed as to Defendants' Self-Dealing

The Third Circuit did not find that the business judgment rule and the doctrine of *in pari delicto* shielded the defendants from liability.<sup>96</sup> The court reasoned that (1) the two occupant deaths, (2) the failure to maintain adequate financial records, (3) the directors' knowledge that the Home's administrator was not working full-time, and (4) the neglected opportunities for success were enough to show that the directors and officers had breached their duty of care.<sup>97</sup> It further found that summary judgment was not appropriate with respect to the business judgment rule because the administrator's and CFO's actions amounted to a dispute of material fact as to whether they acted with the competence and reasonable diligence required to support the presumption offered by the business judgment rule.<sup>98</sup> In addition, the Third Circuit found that the adverse interest exception presented a genuine issue of material fact<sup>99</sup> because the directors and officers were "simultaneously affiliated with both the Home and Lemington Elder Care, and thus stood to benefit from a transfer of the Home's principal charitable asset to Lemington Elder Care."<sup>100</sup>

## 2. Defendants' Active Omissions and Silence Constituted Fraud

The Third Circuit also concluded that summary judgment was inappropriate with respect to the Home's deepening insolvency claim.<sup>101</sup> Because the board delayed its bankruptcy filing for four months,<sup>102</sup> it was silent in its intention to do so,<sup>103</sup> and because the officers contin-

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96. *Id.* at 291.

97. *Id.* CFO Shealey's failure to maintain financial records, Administrator Causey's failure to adequately oversee the Home, and the directors' plan to divert the Home's assets to Elder Care were sufficient evidence to conclude a breach of the duty of loyalty as well. *Id.*

98. *See id.* at 292.

99. The "adverse interest" exception applies if an agent of the principal, although purportedly acting for its principal, abandons its principal's interest and commits fraud for his own benefit. Tracy Bateman Farrell, Annotation, "*Deepening Insolvency*" as Cause of Action in Tort, 23 A.L.R. 6th 457 (2007).

100. *In re Lemington Home for the Aged*, 659 F.3d at 293. The court cited four factual contentions raised by the Committee: (1) the officers and directors had been simultaneously affiliated with both the Home and Elder Care, (2) Shealey had served as a trustee of another potential purchaser, (3) Causey had not accepted a recommendation that she be replaced, and (4) Shealey had failed to properly maintain financial records. *See id.*

101. *Id.* at 295.

102. *Id.*

103. In Pennsylvania, "fraud consists in anything calculated to deceive . . . whether it be by direct falsehood or by innuendo, by speech or silence, word of mouth, or look or gesture." *In re Reichert's Estate*, 51 A.2d 615, 617 (Pa. 1947). Additional evidence of a letter dated March 30, 2005 to the Home's health insurance provider advising them that employee health care coverage was needed for sixty more days along with the delayed bankruptcy filing created an issue of

ued to breach their fiduciary duties until the Home filed for bankruptcy,<sup>104</sup> the court found a genuine issue of material fact as to whether the defendants' fraudulent actions contributed to the deepening of the Home's insolvency.<sup>105</sup>

The Third Circuit did not specifically comment on the viability of the Committee's deepening insolvency claim,<sup>106</sup> but its reversal of summary judgment indicated that deepening insolvency was a cognizable claim for relief.<sup>107</sup>

#### IV. ANALYSIS

In reversing the district court's decision, the Third Circuit was obliged to follow precedent,<sup>108</sup> but it implied that deepening insolvency could be used as an independent claim against the management of nonprofit corporations.<sup>109</sup> The *In re Lemington Home for the Aged* decision reveals more insight on the scope of a deepening insolvency claim than the sufficiency of the defendants' malfeasance. If the Third Circuit had the opportunity to evaluate the viability of the Committee's claim, it would find that deepening insolvency should be an independent claim against the management of a nonprofit corporation for two reasons. First, the directorial obligations of a nonprofit corporation are different from those of a for-profit corporation. Second, although critics have condemned *Lafferty's* reasoning as applied to for-profit corporations, *Lafferty's* stated harms exist within the operation of a nonprofit corporation.

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material fact that the directors consciously defrauded the Home's creditors. *See In re Lemington Home for the Aged*, 659 F.3d at 295.

104. The officers continued commingling of funds and the plan to transfer all assets to Elder Care, failed to collect Medicare receivables, and continued to do business with vendors even though the Home was insolvent. *In re Lemington Home for the Aged*, 659 F.3d at 295.

105. *See id.*

106. The Third Circuit was addressing only the appeal from the grant of summary judgment from the district court. *See id.* at 290.

107. The court pointed out that neither party "argued that the concept of deepening insolvency may not apply to, or may involve a different standard for, a non-profit corporation" and would not address the issue. *Id.* at 294 n.6.

108. "[W]e are bound in our decision to follow *Lafferty*, which recognizes deepening insolvency as an independent cause of action in Pennsylvania." *Id.*

109. Although the court was obligated to follow the *Lafferty* precedent, by reversing the district court's finding that there was no genuine issue of material fact as to the deepening insolvency claim, the Third Circuit did not preclude the Committee from claiming deepening insolvency in the suit. *See In re Lemington Home for the Aged*, 659 F.3d at 294 n.6.



A. *Organizational Differences Between Nonprofit and For-Profit Corporations Create Differences in Their Respective Directors' Duties*

Courts should evaluate the actions of directors of a nonprofit corporation differently than directors of a for-profit corporation because their respective duties of care differ. The duty of care consists of two distinct requirements: director oversight and decision-making.<sup>110</sup> To satisfy the oversight requirement, a director must make a reasonable inquiry into potential issues that a corporation may encounter and must continuously monitor corporate direction.<sup>111</sup> Director oversight requires the attentiveness of an ordinary prudent person in like circumstances.<sup>112</sup> The elements of the director's decision-making function—the director's fiduciary actions and to whom those actions affect—depend on the state in which the entity is incorporated.<sup>113</sup>

In general, when a for-profit corporation becomes insolvent, the director's duty of care shifts from the corporation's equity holders to its creditors.<sup>114</sup> In a solvent, nonprofit corporation, the director should make decisions that intend to benefit the corporation's purpose.<sup>115</sup> However, unlike the for-profit director, when a nonprofit corporation enters the zone of insolvency the law is not clear to whom the director

110. The Revised Model Nonprofit Corporation Act provides that a director fulfills his duty of care by acting "(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation." REVISED MODEL NONPROFIT CORP. ACT § 8.30(a) (1987).

111. See Michael W. Peregrine & James R. Schwartz, *Revising the Duty of Care of the Nonprofit Director*, 36 J. HEALTH L. 183, 188–89 (2003).

112. See *id.* at 188. Some observers focus on the following actions/inaction that reflect failure of the director to exercise oversight: (1) a weak system of corporate governance compounded by large, multiple overlapping boards; (2) a low degree of fiscal responsibility and oversight practice by the governance; (3) weak board composition; (4) multiple conflicts of interest between the board and officers; (5) CEO domination of all board decisions; and (6) little board oversight of corporate management and officers. Lawton R. Burns et al., *The Fall of the House of AHERF: The Allegheny Bankruptcy*, 19 HEALTH AFF. 7, 8, 21–23 (2000).

113. See Peregrine & Schwartz, *supra* note 111, at 196–97 (recognizing that there are numerous cases evaluating the decision-making function).

114. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 WL 277613, at \*1157 (Del. Ch. Dec. 30, 1991) (implying that the directors shift their fiduciary duties to creditors to sustain the corporation); see also J. William Boone & Nadja Bailey, *Not-for-Profits in Bankruptcy: Who Doesn't Love a Charity?*, 23 BNA BANKR. L. REP. 1064, n.14 (2011) (noting that the duty of care usually shifts to creditors once a for-profit corporation is no longer solvent).

115. In a similar, solvent for-profit corporation, the director is required to make fiduciary decisions with the corporation's shareholders in mind to maximize its long-term profits. Nonprofit corporations do not have any similar equity interests. See Boone & Bailey, *supra* note 114; see also Peterman & Morissette, *supra* note 11 ("[D]irectors of a nonprofit corporation owe a duty to fulfill the corporate purpose of the organization.").

owes this duty.<sup>116</sup> For the purposes of this Note it is appropriate to determine the director's duty within an insolvent nonprofit corporation using a similar rationale to the for-profit director's shift from shareholders to creditors.<sup>117</sup>

Regardless of whether the nonprofit director's duty shifts when a corporation enters the zone of insolvency, the director will be compelled to make the appropriate fiduciary decisions in the interest of the nonprofit corporation. The main difference between for-profit and nonprofit corporations is that the latter is not formed to profit from its operations and thus has no profit-driven motive.<sup>118</sup> Nonprofit corporations typically exist for charitable and other benevolent purposes, and its contributors fund these entities because of such altruistic aspirations.<sup>119</sup> Upon insolvency, if the nonprofit director's duty does not shift from the corporation to its creditors, it would still be acting as if it would have shifted because its creditors have invested in the nonprofits' goals, not their own.<sup>120</sup>

More importantly, even if the decision-making duty of the nonprofit director shifts *solely* to protect creditors,<sup>121</sup> a nonprofit corporation should still be the primary recipient of its director's decisions. Creditors that contribute to a nonprofit corporation assume the same risk of nonpayment as with their contributions to for-profit corporations.<sup>122</sup> Further, a nonprofit corporation's federal tax status permits the government to monitor a nonprofit's management to "ensure it is operating for the benefit of those whom it was formed and whose purpose it serves."<sup>123</sup> Therefore, even if the nonprofit director's decision-making duty shifts to the creditors when a nonprofit corporation becomes insolvent, the director maintains his ongoing duty to protect the purpose of the corporation.

If it had the opportunity, the Third Circuit would find that the directors of the Home did not properly exercise their required duty of

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116. "It is clear that when in the zone of insolvency duties of directors of public or private corporations shift from profit maximization to protecting the assets of the estates for the benefit of creditors. However, it is not so clear who the directors owe a fiduciary duty to in the case of nonprofit corporations." Peterman & Morissette, *supra* note 11.

117. *See id.*

118. *Id.* (noting that a board of directors of a solvent corporation generally owes only a duty to maximize its shareholders' profits, but nonprofit directors owe a duty to fulfill the corporate purpose of the organization).

119. *See id.*

120. While the corporation is solvent, nonprofit directors owe a duty to fulfill the corporate purpose of the organization. *Id.*

121. *See* Boone & Bailey, *supra* note 114.

122. Peterman & Morissette, *supra* note 11.

123. *Id.*

care. Although there is no significant statutory difference between a nonprofit and for-profit corporation,<sup>124</sup> the directors, applying the reasons of the oversight and decision-making functions above, violated their duty of care to the Home. The fact that the directors did not supervise the CFO, appoint a new administrator,<sup>125</sup> or ensure that someone recorded executive meetings was sufficient evidence to demonstrate that the directors did not adequately oversee the Home.<sup>126</sup> In addition, when the Home became insolvent, the directors ignored their continuing duty to make decisions in the interest of the Home's corporate purpose.<sup>127</sup> Their decision to delay bankruptcy and instead provide a plan for Elder Care to absorb the Home's assets violated the Home's best interests.<sup>128</sup>

To summarize, because the differences between for-profit and nonprofit corporations change the elements of the nonprofit director's duty of care and the Home's directors lack of oversight in monitoring the Home deepened the Home's insolvency, they violated their duty of care. The duty of care requirements of nonprofit directors and the evidence of the Home's demise indicate a gap in the claims for relief against nonprofit corporate management. A claim of deepening insolvency is best suited to fill this void.<sup>129</sup>

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124. The only difference between the corporate standard of care statutes in Pennsylvania is the type of corporation mentioned. *Compare* 15 PA. CONS. STAT. ANN. § 512 (West 2011) ("A director of a domestic corporation shall stand in a fiduciary relation to the corporation and shall perform his duties as a director . . . in good faith, in a manner he reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances."), *with* § 5712 ("A director of a nonprofit corporation shall stand in a fiduciary relation to the corporation and shall perform his duties as a director . . . in good faith, in a manner he reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances.").

125. The failure to appoint a full-time administrator resulted in two separate deaths in the home during Administrator Causey's absence. Official Comm. of Unsecured Creditors v. Baldwin (*In re* Lemington Home for the Aged), 659 F.3d 282, 286–87 (3d Cir. 2011).

126. It is evident that the directors did not reasonably inquire into potential issues, eventually forcing the Home into further insolvency. *See id.*

127. "Lemington Community Services provide . . . programs and services to the elder population of Pittsburgh's East End that support the independent living; decrease isolation and premature institutionalization; promote mental, physical, and financial health and stability; and provide referrals to other essential resources . . ." *About Us*, LEMINGTON COMMUNITY SERVICES, [http://www.lemingtoncs.org/index.php?option=com\\_content&view=article&id=4&Itemid=3](http://www.lemingtoncs.org/index.php?option=com_content&view=article&id=4&Itemid=3) (last visited Mar. 22, 2013) (explaining the Home's corporate purpose).

128. In addition to its failure to make decisions that benefited the Home, the directors' action to consolidate the Home into Elder Care was an active decision to hurt the Home because it is likely that the directors would continue to manage Elder Care in the same manner as the Home. *See In re Lemington Home for the Aged*, 659 F.3d at 291.

129. This Note succinctly evaluated the Home's receipt of the duty of care because the Third Circuit addressed the business judgment rule in its opinion. *See id.* at 291–93 (explaining why the business judgment rule and *in pari delicto* did not apply).

B. *Lafferty's Potential Harms Fill the Existing Gap in Claims Against the Management of a Nonprofit Corporation*

In concluding that the Pennsylvania Supreme Court would recognize deepening insolvency as an independent claim,<sup>130</sup> the *Lafferty* court, drawing guidance from other Third Circuit opinions, identified four potential harms that a deepening of a corporation's insolvency would have on its operations.<sup>131</sup> First, the court stated that the fraudulent and concealed accumulation of debt could force an insolvent corporation into bankruptcy, inflicting legal and administrative costs that hurt its ability to run a profitable business.<sup>132</sup> Second, the deepening of a corporation's insolvency could undermine its relationship with its customers, suppliers, and employees.<sup>133</sup> Third, it could cause the dissipation of corporate assets simply by prolonging an insolvent corporation's life through bad debt.<sup>134</sup> Fourth, the nondisclosure of a corporation's deepened insolvency could harm shareholders because it prevents dissolution of the corporation.<sup>135</sup>

Academic scholars have offered opinions that discredit the *Lafferty* court's "harms" and have asserted that deepening insolvency is, at best, a measurement of damages,<sup>136</sup> but their theories do not consider the harms' effects on nonprofit corporations. *Lafferty's* harms are a significant threat to nonprofit corporations, and a claim of deepening insolvency is best suited to prevent damage.

Addressing the first harm, critics disagree with the *Lafferty* court's belief that the incurrence of debt will have significantly hurt corporate operations.<sup>137</sup> Mr. Sabin Willett believes that a plaintiff would have difficulty proving that the fraudulent accumulation of debt itself was enough to avoid bankruptcy.<sup>138</sup> He supports the argument by noting that corporations will act fraudulently when they lack a valid purpose in the marketplace.<sup>139</sup> He reasons that when bankruptcy is inevitable, with or without fraud, the plaintiff faces a challenge to meet its burden of proof, and courts will view any offered proof with great skepti-

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130. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349 (3d Cir. 2001).

131. *Id.* at 349–50.

132. *Id.*

133. *Id.* at 350.

134. *Id.*

135. *Lafferty*, 267 F.3d at 350.

136. See, e.g., Willett, *supra* note 39, at 564; see also Goodwin, *supra* note 12, at 41.

137. Willett, *supra* note 39, at 565; Goodwin, *supra* note 12, at 37–38.

138. Willett, *supra* note 39, at 565.

139. *Id.*

cism.<sup>140</sup> Mr. John Goodwin advances Mr. Willett's conclusion, stating that the benefits of bankruptcy reorganization often outweigh the associated administrative and legal costs.<sup>141</sup>

Mr. Willett's and Mr. Goodwin's theories have a strong foundation, and their breadth makes it easy to understand and apply in most situations, but their general proposition that bankruptcy is inevitable for poorly functioning corporations does not include a situation in which fraudulent action eliminates a corporation's options *within* bankruptcy.

Courts should recognize a claim for deepening insolvency when the misuse of nonprofit corporate assets forces a corporation to file for bankruptcy. Bankruptcy reorganization is an extremely flexible tool, and the bankruptcy courts have the equitable powers to allow a reorganization or liquidation plan that considers the interests of both debtors and creditors.<sup>142</sup> In *In re Parmalat*, the court rejected a dairy producer's deepening insolvency claims based on its incurrence of liabilities and stated that the plaintiff's true claim was that the prolongation of its life through bad debt caused the dissipation of its assets.<sup>143</sup> The court suggested that the only approach to a deepening insolvency claim that could pass muster is if the corporate managers damaged the corporation through the misuse of its assets.<sup>144</sup> The court further set forth a requirement that a defendant manager must have had knowledge of its fraud and used it to waste plaintiff's assets.<sup>145</sup>

The *In re Parmalat* approach considers a corporation's incurrence of assets as well as its debt because a corporation acquires more than a liability when it accumulates a note payable.<sup>146</sup> The additional analysis shifts a court's damage evaluation to a corporation's use of assets that it obtained through debt, and therefore, the claim provides a better view of a director's decision-making and creates a more formidable proximate cause barrier for the plaintiffs to overcome.<sup>147</sup> Although the *In re Parmalat* approach varies from deepening insolvency's traditional evaluation of whether the further accumulation of

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140. *Id.*

141. Goodwin states that the bankruptcy proceedings provide protection from creditors, access to lenient financing, and "leverage to force individual parties to support a viable plan of reorganization." Goodwin, *supra* note 12, at 38.

142. *In re Parmalat* Sec. Litig., 501 F. Supp. 2d 560, 578 (S.D.N.Y. 2007).

143. *Id.* at 576.

144. Tanis & Fease, *supra* note 3, at 247.

145. *In re Parmalat*, 501 F. Supp. 2d at 581-87 (finding the plaintiffs failed to allege conduct that would give rise to an inference of actual knowledge and did not adequately allege that the defendant knew that management was committing fraud).

146. Tanis & Fease, *supra* note 3, at 245.

147. *Id.* at 245-46.

corporate debt fraudulently prolonged a corporation's life and may not apply solely to nonprofit corporations,<sup>148</sup> evaluating how a corporation uses its assets is a beneficial methodology to recognize the improper prolongation of a corporation's life. The *In re Parmalat* approach uncovers additional value left in the corporation and minimizes speculation as to whether filing for bankruptcy earlier would have been beneficial.<sup>149</sup>

Further, the court in *In re Parmalat* commented on the use of deepening insolvency when bankruptcy is inevitable for a corporation.<sup>150</sup> In the case, the dairy producer could have reorganized its debt in Chapter 11 and remained in operation; however, their directors delayed filing, and the producer was forced to file for liquidation.<sup>151</sup> Although the plaintiff's burden of proof is difficult, the *In re Parmalat* court did not outright reject a claim for deepening insolvency because the fraudulent incurrence and concealment of debt may have harmful effects on a corporation destined for bankruptcy.<sup>152</sup>

Regarding *Lafferty's* second harm, Mr. Willett and Mr. Goodwin believe that an insolvent corporation's continued incurrence of debt does not initiate any further strain on the relationships with its customers, employees, and community because by the time a corporation is insolvent it has already strained its relationship with these groups beyond repair.<sup>153</sup> The authors claim that *Lafferty's* alleged harm is contrary to reality and instead believe that a corporation that has wrongfully acted through fraud or distressed borrowing wants only to improve its reputation and quell the initial threats of bankruptcy.<sup>154</sup> Moreover, they believe it is best for the parties harmed to embrace the positive effects of bankruptcy.<sup>155</sup>

The argument that deepening insolvency causes no future strain on a corporation's relationships may be generally correct, but it is incomplete. Any strain on such parties originates from their dependency on the corporation, and although both authors correctly imply that customers, suppliers, and employees are interested parties, they fail to distinguish the severity of their interest in a for-profit corporation's

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148. This inquiry is beyond the scope of this Note.

149. *In re Parmalat*, 501 F. Supp. 2d at 578.

150. *See id.* at 576.

151. *Id.*

152. The plaintiff must possess facts that could establish above a speculative level that the company could have reorganized earlier and avoided bankruptcy. *Id.* at 572.

153. Willett, *supra* note 39, at 565; Goodwin, *supra* note 12, at 38.

154. Willett, *supra* note 39, at 565; Goodwin, *supra* note 12, at 38.

155. Goodwin, *supra* note 12, at 38.

equity—the value of its stock—from a nonprofit corporation's current and future value—its corporate purpose.

Nonprofit corporations do not have equity holders like for-profit corporations. Because the purpose of nonprofit corporations is to further the corporate mission, not to create a profit, its directors do not owe the same duty to shareholders like for-profit corporations.<sup>156</sup> Simply put, a nonprofit director is not obligated to please stockholders.<sup>157</sup> The nonprofit director is, of course, still interested in the equity of the corporation, but he has a duty to fulfill the corporate purpose even when the corporation becomes insolvent.<sup>158</sup>

Furthermore, when a nonprofit director fraudulently takes on more debt, his failure to adhere to the corporate purpose harms the beneficiaries of the nonprofit more than those with equity interests. The purpose of a nonprofit is grounded in a charitable, benevolent, or religious commitment.<sup>159</sup> The period after a nonprofit corporation becomes insolvent is just as important as its solvent operation because its beneficiaries<sup>160</sup> still benefit from the entity well after it becomes insolvent.<sup>161</sup> In addition, the beneficiaries may depend more on a nonprofit corporation's equity than shareholders because they have more than money invested in the corporation: beneficiaries rely on the corporation's operation and its contribution to the community, in some instances, to live.<sup>162</sup>

Mr. Willett and Mr. Goodwin agree that *Lafferty's* third potential harm, in which a delayed liquidation harms an insolvent corporation, is not valid because there is no need to prevent the dissipation of an insolvent corporation's assets.<sup>163</sup> When a corporation files for Chapter 7 bankruptcy, the bankruptcy trustee liquidates corporate assets and distributes the proceeds to its creditors.<sup>164</sup> The authors also agree that a delay in bankruptcy may cause harm to creditors because there are fewer assets to distribute when a corporation eventually files for

156. Peterman & Morissette, *supra* note 11, at 3.

157. *Id.*

158. See *supra* notes 116–22 and accompanying text.

159. Peterman & Morissette, *supra* note 11, at 3.

160. The nonprofit beneficiaries are people or communities that benefit from the corporate purpose. The Home's beneficiaries were the residents, the residents' families, employees, and the Pittsburgh community.

161. For example, the Home remained in operation after it became insolvent. Official Comm. of Unsecured Creditors v. Baldwin (*In re* Lemington Home for the Aged), 659 F.3d 282, 285 (3d Cir. 2011).

162. Because the residents lived in the Home after it became insolvent, the beneficiaries relied on the Home for shelter, food, and other necessities. See, e.g., *id.*

163. Willett, *supra* note 39, at 566.

164. *Id.*

liquidation, but if asset liquidation is inevitable, any delay “add[s] insult only to death” because corporate life is already defunct.<sup>165</sup> Consequently, they discredit any harm that originates from a corporation’s delayed liquidation because, at the point of insolvency, shareholders are the last in line to recover proceeds and therefore are not likely to receive anything from dissolution.<sup>166</sup>

Unlike the director of a for-profit corporation, the director of a nonprofit corporation has a duty to manage the corporate assets in furtherance of the organization’s stated charitable mission and act in accordance with the best interests of its beneficiaries.<sup>167</sup> The directorial duty of obedience embodies the duty to ensure a nonprofit corporation’s charitable mission.<sup>168</sup> The duty of obedience requires the nonprofit director to carry out corporate objectives as specified by the corporation’s mission, which, for example, controls the issue of whether a sale of all corporate assets promotes the purpose of the nonprofit corporation.<sup>169</sup> Because a nonprofit corporation may continue to operate past insolvency<sup>170</sup> and the duty of obedience requires that the directors make decisions in the best interests of the corporate mission,<sup>171</sup> a nonprofit corporation may suffer harm from the dissipation of its corporate assets because of a delayed liquidation.

Finally, in support of *Lafferty*’s fourth harm, the director’s failure to disclose a nonprofit corporation’s insolvency may cause significant harm to the beneficiaries of its charitable purpose.<sup>172</sup> In the zone of insolvency, the for-profit director’s duties shift from profit maximization for shareholders to asset preservation for creditors.<sup>173</sup> However, when a nonprofit corporation enters the zone of insolvency, the director must determine whether he may shift his duties to benefit the

165. *Id.* (claiming that *Lafferty*’s third harm is invalid).

166. *Id.* at 561; Goodwin, *supra* note 12, at 39.

167. Boone & Bailey, *supra* note 114, n.15 (citing *Summers v. Cherokee Children & Family Servs.*, 112 S.W.3d 486, 504 (Tenn. Ct. App. 2002)).

168. *E.g.*, *Manhattan Eye, Ear, & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 593 (N.Y. Sup. Ct. 1999).

169. *E.g.*, *id.*

170. See *supra* notes 158–61 and accompanying text.

171. “While it may be appropriate, in certain cases, to solve financial difficulties by eliminating the organization’s mission by selling its assets and then undertaking a new mission, . . . the duty of obedience . . . mandates that a [b]oard, in the first instance, seek to preserve its original mission.” *Spitzer*, 715 N.Y.S.2d at 595.

172. Mr. Willett and Mr. Goodwin agree, on similar grounds as *Lafferty*’s third potential harm, that its fourth harm, the nondisclosure of a corporation’s insolvency, is invalid because any residual value left in the corporation will be distributed to its creditors. See Willett, *supra* note 39, at 561; Goodwin, *supra* note 12, at 39.

173. Peterman & Morissette, *supra* note 11, at 3.



creditors or continue to fulfill the corporate mission.<sup>174</sup> Regardless, the nonprofit director cannot push his corporation's beneficiaries to the end of the asset distribution during liquidation, as a for-profit director does to its shareholders, because the nonprofit director must adhere to his duty of obedience.<sup>175</sup> The failure to disclose a nonprofit corporation's insolvency is the most likely of *Lafferty's* harms that could result from deepening insolvency because the director of a nonprofit corporation has a duty to its beneficiaries, and without disclosure, its beneficiaries will be last in line to recoup anything from dissolution.

In sum, the Third Circuit's failure to elaborate in *In re Lemington Home for the Aged* did not harm the decision's ability to affect the future viability of deepening insolvency claims. By reversing the district court, it not only recognized that the directors and officers may have fraudulently prolonged the life of the Home, but also implicitly recognized the differences between nonprofit and for-profit corporations and the associated duties of their directors. If the court had further developed its opinion, it could have reasoned that because of the differences in the duty of care and the potential harms associated with deepening insolvency, an independent claim of deepening insolvency could remedy the harm caused by directors of a nonprofit corporation.

## V. IMPACT

The *In re Lemington Home for the Aged* decision could have substantial ramifications in allowing deepening insolvency claims against directors of nonprofit corporations. Currently, courts have not established a consistent view on deepening insolvency.<sup>176</sup> Some jurisdictions that have distinguished the operations of nonprofit corporations from for-profit corporations have addressed, and even rejected, deepening insolvency.<sup>177</sup> However, because of the inconsistencies across the courts, there is little likelihood that deepening insolvency will ever reach final determination as to nonprofit corporations. Deepening in-

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174. *Id.*

175. See *supra* notes 167–70 and accompanying text.

176. See Richmond, *supra* note 55, at 131–32 (stating that deepening insolvency claims are common, but not all courts recognize the claim and those that do treat the allegations as an independent claim or just a theory of damages); see also *supra* notes 32–38 and accompanying text.

177. Compare *Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168 (Del. Ch. 2006) (rejecting deepening insolvency theory in any form), with *Denckla v. Independence Found.*, 193 A.2d 538 (Del. 1963) (noting the duty of obedience places outer limits on what an organization may do by way of modifying activities).

solvency's vacillating precedent<sup>178</sup> and the discordance of nonprofit corporate law's regulations and policy have created significant barriers that may prevent the issue from reaching the Supreme Court.

Directors must possess sufficient qualifications to effectively manage both for-profit and nonprofit corporations, but current qualification standards prevent the courts from conducting detailed director evaluation. For example, corporations tend to require that their directors have a broad knowledge base to represent various constituencies and remain committed to the corporate mission.<sup>179</sup> Although scholarly opinion has expounded on the qualifications of nonprofit directors,<sup>180</sup> there is no bright-line standard beyond the duty to act as an ordinary prudent person in like circumstances.<sup>181</sup> Moreover, the evaluation of director qualification standards is inconsistent because of the numerous qualification exceptions recognized in litigation.<sup>182</sup> Courts must reexamine this standard before they evaluate directorial duties across for-profit and nonprofit corporations.

In addition, the inconsistencies across nonprofit regulation and litigation are attributable to the conflicting policy interests of the corporate fiduciary duty and charitable social utility. The main objectives of the corporate fiduciary duty (and its counterpart, the business judgment rule) is to ensure directors serve their principals' interests and overcome the high oversight costs inherent in the corporate form.<sup>183</sup> This traditional corporate structure is adequate for for-profit corporations because corporate shareholders act as a secondary oversight tool.<sup>184</sup> However, the additional safeguard of the shareholder is present only in a for-profit corporation; a nonprofit corporation does not have traditional shareholders and thus does not have principals with sufficient legal control to monitor director abuse.<sup>185</sup> The lack of a secondary safeguard for the corporate structure potentially enables directors to shirk their fiduciary obligations if incentives to forego such duties are as cost-effective as they were in *In re Lemington Home for the Aged*.

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178. See Magalhaes & Wolper, *supra* note 78, at \*32 (noting most courts have rejected deepening insolvency but others have found it a valid cause of action).

179. Peregrine & Schwartz, *supra* note 111, at 206.

180. See, e.g., Peregrine & Schwartz, *supra* note 111; Peterman & Morissette, *supra* note 11.

181. Peregrine & Schwartz, *supra* note 111, at 187.

182. *Id.* at 205.

183. Thomas L. Greaney & Kathleen M. Boozang, *Mission, Margin, and Trust in the Non-profit Health Care Enterprise*, 5 YALE J. HEALTH POL'Y L. & ETHICS 1, 34 (2005).

184. *Id.*

185. *Id.*

Moreover, a charitable organization's goal to provide social utility to its community undermines the efficacy of its corporate fiduciary duty. The measurement of social benefit is ambiguous, which can cause the nonprofit to deviate from its for-profit corporate structure and prevent it from supervising its directors' actions.<sup>186</sup> To successfully provide social utility, nonprofit directors must reconcile the corporate mission with the need to generate sufficient net income to continue operations.<sup>187</sup> However, a corporate mission is stated often in general terms that lack the quantifiable framework required for successful implementation, which further complicates a nonprofit corporation's direction.<sup>188</sup> The flexible standards of a nonprofit's mission may also invite regulations that bring otherwise efficient business strategies to a standstill.<sup>189</sup> Because, to some degree, the fiduciary duty and social utility goals of a nonprofit interfere with each other's success, courts have struggled to consistently reconcile their respective priorities. Thus, an effective nonprofit corporate evaluation must involve a substantial appraisal of its own policy goals; otherwise, existing circumstances may force it to sacrifice one goal to ensure the success of the other.

It is unlikely that the Supreme Court will have a chance to rule on a situation similar to *In re Lemington Home for the Aged* because of the inconsistent views of deepening insolvency, the difficulty in developing an accountability standard for directors of nonprofit corporations, and the differing policy interests involved with a distressed nonprofit corporation. Furthermore, the number of lawsuits that reach trial involving nonprofit corporations are significantly less than for-profit litigation.<sup>190</sup> Nonetheless, the current circumstances of the law should not take anything away from the impact of the Third Circuit's opinion in *In re Lemington Home for the Aged*.

## VI. CONCLUSION

Deepening insolvency is a valuable claim for corporate owners and creditors that have suffered from the fraudulent and continuous ac-

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186. *Id.* at 36.

187. *Id.*

188. Greaney & Boozang, *supra* note 183, at 36.

189. *Id.* at 36–37.

190. For example, a search on WestlawNext produced sixty-seven nonprofit cases that discussed the duty of care for a nonprofit corporation. WESTLAWNEXT, <http://www.next.westlaw.com> (search “‘duty of care’ /5 director! trustee & nonprofit charitable not-for-profit”) (last visited Mar. 22, 2013). A similar search yielded 653 cases. *Id.* (search “‘duty of care’ /5 director!”) (last visited Mar. 22, 2013); see also Greaney & Boozang, *supra* note 183, at 37 nn.137–39 (performing a similar Westlaw search).

cumulation of debt at the behest of corporate managers. The *In re Lemington Home for the Aged* decision is illustrative of a scenario in which deepening insolvency is not merely “duplicative of other recognized causes of action such as breach of fiduciary duty.”<sup>191</sup> The Third Circuit’s decision in *In re Lemington Home for the Aged* gave new life to a misunderstood claim for relief when it did not foreclose the application of deepening insolvency to the fraudulent operation of an insolvent nonprofit corporation.

Although the Third Circuit’s decision leaves no quotable reasoning to carry its principles forward, the decision places directors of potentially insolvent nonprofit corporations in a more vulnerable position. If read narrowly, nonprofit directors that engage in active mismanagement, conflicts of interest, and intentionally deceptive practices could potentially be subject to a claim of deepening insolvency.<sup>192</sup> If interpreted broadly, which this Note suggests, a nonprofit corporation’s delayed bankruptcy filing should be grounds for liability in all instances because the directorial duties within a nonprofit corporation do not emulate the flexibility and deference of those within a for-profit corporation. Indeed, *In re Lemington Home for the Aged* and other precedent have indicated that deepening insolvency remedies fraud that, when it occurs within nonprofit corporations, cannot be corrected by other claims for relief.

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191. Magalhaes & Wolper, *supra* note 78, at \*32.

192. *Id.*

